COPELAND WHITE PAPER I: The Surprising Impact of Draconian Tax Policy on Dividends

"We believe that a company's dividend growth rate is the most significant driver of its total return."

A comprehensive look at the relationship between changes in tax rates and 1) the returns of dividend-oriented investing styles and 2) corporate dividend policies

Executive Summary
As it stands today, barring a political compromise, the highest tax rate payable on dividends will jump from 15.0% to 43.4% for the 2013 tax year. That sets up two important questions for investors in dividend-oriented strategies. First, how will the securities of dividend payers and dividend growers perform relative to the market as investors are forced to share a larger portion of their income with the government? And second, will companies opt to put their cashflows to alternative uses, such as stock buybacks or M&A, rather than grow their dividends?

Key Takeaways:

- The performance of dividend-oriented strategies, including the performance of hypothetical, historical portfolios constructed using Copeland's discipline, did not demonstrate any significant relationship with tax rates during years when significant changes were enacted.

- Corporate dividend policies also showed no relationship with changes in tax rates.

- The performance of dividend growth stocks appears to be more closely linked with the economic cycle than either absolute tax rates or changes in tax rates.

Our Methodology

If tax rates really drive investing decisions, we would expect dividend strategies to have underperformed the market when rates were rising and to have outperformed when rates were falling. To determine whether or not this was the case, we created three hypothetical, capitalization-weighted portfolios:

- **Dividend Payers** – The "dividend payers" portfolio was comprised of all US traded companies with market capitalizations above $1 billion that paid a dividend in the prior year.

- **High Yielders** – The "high yielders" portfolio was constructed by sorting the "dividend payers" portfolio (see above) by sector, then by yield, from highest to lowest. The lowest yielding 80% of companies within each sector were then removed, leaving the highest yielding 20%.

- **Dividend Growers** – The "dividend growers" portfolio was constructed analogous to Copeland's traditional investable universe. It included all US traded companies with market capitalizations greater than $1 billion that had progressively increased their dividends in each of the preceding five years.

Within each portfolio, sector weightings were aligned with those of the S&P 500 Index in order to remove any sector bias. Each portfolio was reconstituted annually on January 1st to add or remove any companies as required based on changes in their dividend policies or yield levels. Sector weightings were also re-aligned on January 1st of each year to bring the portfolio sector weightings back in-line with those of the Index.

Tax Rates on Dividends Don't Affect Performance of Dividend-Oriented Investing Strategies

With tax rates on dividends declining fairly steadily for nearly 50 years, historical examples from which to extrapolate return expectations in a rising tax rate environment are rare. There are however two examples of tax increases from the recent past that we can study to discern whether any relationship exists between the relative performance of dividend-oriented investing strategies and changes in tax rates. In 1991, the top marginal income tax rate increased from 28.0% to

31.0%, while in 1993 it rose again to 39.6%.[1] As adjustments in rates happen at a point in time, rather than over the course of time, it is, in our opinion, most relevant to look at the performance in the year leading up to the rate change and in the year during which the change was first implemented. We consider the year leading up to the change (i.e. 1990 or 1992, respectively) because we believe it most accurately reflects the time during which investors, if they are indeed concerned about taxes in their portfolio construction, would have been most attuned to the rhetoric surrounding the upcoming adjustment and therefore repositioned their portfolios. Furthermore, we consider the year in which the change was ultimately implemented (i.e. 1991 or 1993) because that was the year in which investors would actually have felt the impact of the rate change in their after-tax cashflows from dividends.

The period from December 31, 1989 through December 31, 1993 was particularly interesting to study given the varied market environments included therein. Equity market returns began weakly due to recessionary pressures and concerns about the first Gulf War. They quickly recovered when interest rates and energy prices fell, and ultimately finished with two years of fairly normal returns by historical standards (see Table 1).

Traditionally, absent any concerns about taxes, in a weak period one might expect outperformance from dividend stocks due to the relative stability in their business models. By contrast, it sometimes proves difficult for them to keep pace in aggressive rallies as investors opt to take on additional risk. Remarkably though, the portfolio of dividend payers outperformed in all four years, posting an annualized total return of 12.0%, versus an annualized total return of 10.7% for the S&P 500 Index. The "high yielders" and "dividend growers" portfolios were even more successful, posting more impressive annualized total returns at 12.3% and 13.6%, respectively, and outperforming in three of the four years.[2]

Table 1

The total returns of dividend payers, high yielders and dividend growers consistently outpaced the S&P 500 Index even as tax rates rose from 1990 through 1993

	Dividend Payers	High Yielders	Dividend Growers	S&P 500 Index	Highest Marginal Tax Rate
1990	-1.4%	-7.8%	4.0%	-3.4%	28.0%
1991	31.0%	33.7%	35.7%	31.0%	31.0%
1992	10.2%	10.7%	9.8%	7.6%	31.0%
1993	10.7%	16.5%	7.4%	10.2%	39.6%
Full Period Annualized	12.0%	12.3%	13.6%	10.7%	

Alternatively, we also looked at the performance of the three portfolios in 2002 and 2003, as the top tax rate on dividends fell from 35% to 15% in the latter year.[1] Again, we considered a two-year period to accommodate the fact that investors would have been attuned to rhetoric surrounding tax law changes in the year leading up to the actual implementation thereof. If tax rates drive the relative performance of dividend strategies, we would expect them to have outperformed significantly in light of such a favorable change. Like 1990-1991, 2002-2003 was also a period that began very weakly, followed by strong performance as the economy recovered (the Index fell -22.3% in 2002, then rallied 28.7% in 2003), resulting in flat performance for the full period.

Again, dividend strategies appeared to show little correlation with tax rate changes. All three portfolios outperformed the Index by a wide margin in 2002 (see Table 2). This is not unexpected, given the market weakness. However, in 2003, as the market rebounded, only the "high yielders" portfolio (with a total return of 34.16%) beat the Index (see Table 2).[2] Collectively, these results increase our comfort that the performance of dividend-oriented strategies – including Copeland's Dividend Growth approach – are not likely to be driven by tax rate changes. Instead, we expect that returns for dividend growth stocks will be driven by the economic cycle, outperforming in all periods but the early acceleration

Table 2

While the total returns of high yielders outpaced the S&P 500 Index as tax rates fell from 2002 through 2003, dividend payers and dividend growers didn't behave as expected

	Dividend Payers	High Yielders	Dividend Growers	S&P 500 Index	Highest Marginal Tax Rate
2002	-18.3%	-10.3%	-18.6%	-22.3%	35.0%
2003	28.5%	34.2%	22.1%	28.7%	15.0%
Full Period Annualized	2.5%	9.7%	-0.3%	0.0%	

phase. Early acceleration occurs after a cyclical downturn and is generally characterized by outperformance of lower quality names with weak balance sheets, highly cyclical business models and in many cases, ironically, high yields resulting from sharp price declines in stocks that once offered more modest yields. While some of these "high yielders" may have made it into our "high yielders" portfolio due to the "point in time" nature of the historical model we created to test returns, it is worth pointing out that, in practice, dividend investors should approach them with caution. Yields that appear unusually high, either relative to historical or industry norms are often reflective of a broad investor belief that a dividend cut or elimination is soon to occur.

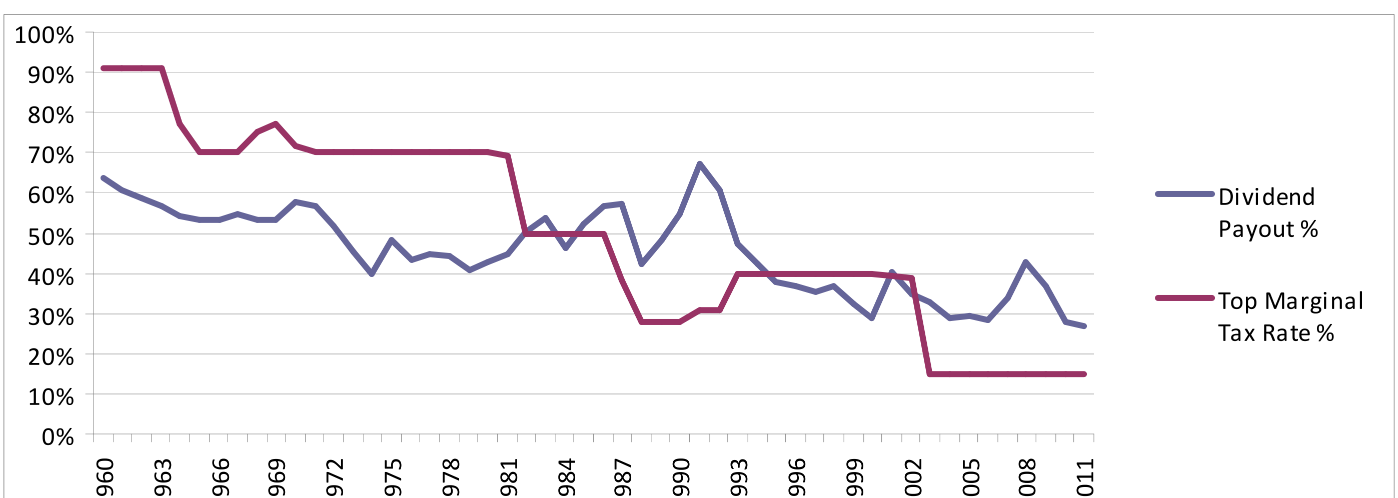
Tax Rates on Dividends Do Not Influence Corporate Behavior

The second equally critical question for dividend investors as tax rates change is: will corporate management teams opt for other uses of cash as rates rise? Indeed, it is no good to say that dividend strategies can outperform regardless of tax policy if the investable list of dividend payers and consistent dividend growers are about to be thinned dramatically.

Fortunately, similar to what we observed in terms of return patterns, corporate dividend policy appears to have little to do with the tax rate levied on dividends. Our research covering 51 years of S&P 500 Index data, which encompassed six distinct periods of tax policy, shows that neither dividend growth, nor adjusted dividend growth (annual dividend growth less annual earnings growth) reflects any relationship with the prevailing tax rate of the time (R^2 = 0.0009 and 0.0023, respectively).[1,3] Moreover, while the top tax rate on dividends has fallen from 91% in 1960 to 15% today, we were surprised to observe that the dividend payout of the S&P 500 Index, as a percentage of S&P 500 earnings, has also consistently declined from almost 64% to a record low of 27% in 2011 (see Chart 1).[1,3] This relationship clearly shows that falling tax rates did not boost payout policies historically, therefore it would be unreasonable to automatically assume that payouts will fall in 2013 if tax rates rise. While the falling trend in corporate payout policy over time is disappointing, in light of Copeland's strong belief that *a company's dividend growth rate is the most significant driver of its total return,* we are nonetheless heartened by four factors. First, in dollar terms, total dividends paid by S&P 500 companies still grew at a 5.2% annualized rate over the period.[3] Second, the growth was fairly consistent, with dividends rising in 44 of the last 51 years, including 1991 and 1993, and falling only when earnings were under pressure.[3] Third, the breadth of participation has been expanding recently, with 298 names from the S&P 500 raising their dividends at least once in 2011, the largest number in 22 years, and nearly double the number seen during the recession of 2009.[4] And finally, within Copeland's universe of potential investments, shareholders are accustomed to consistent annual dividend increases and management teams treat dividend growth as a philosophical decision, driven not by tax policy, but by the belief that returning a growing income stream sends a perpetual message of confidence in their business models. Holding the payout flat or reducing it would risk undermining that confidence.

It is also notable, as it relates to the current corporate thinking on dividend policy, that 2012 is off to a strong start in

Chart 1



terms of dividend activity. Among S&P 500 Index constituents, through June 30, 2012, there have been a total of 209 positive dividend actions (i.e. initiations or increases) versus only 205 and 140 positive dividend actions in the corresponding periods of 2011 and 2010, respectively. Moreover, the dollar increase in dividends among the 209 S&P 500 constituent companies that have raised their dividends so far this year is $31.62B, well more than the $25.79B increase in the same period last year.[5]

This is better than what we observed during the 1990-1993 period of tax increases, when the number of S&P 500 Index constituents increasing their dividends for the full year initially dropped from 255 (1990) to 216 (1991), before rebounding to 241 (1992) and ultimately finishing the period at 246.[4] It is worth noting however, that the decline in growers was very likely precipitated by consecutive years of declining S&P earnings (-6.9% in 1989 and -14.8% in 1990) rather than by tax policy.[3] Alternatively, 2002 and 2003 both experienced increases in the number of companies raising their dividends (from 171 in 2001 to 173 in 2002 and 221 in 2003), which is not surprising, regardless of the tax rate change, given the significant earnings growth experienced in both years (18.5% and 18.8%, respectively).[3,4] Together, these results again lend credence to our belief that corporate dividend policy, similar to the relative performance of dividend-oriented investment strategies, is more likely to be a function of the stability of corporate cashflows and the economic cycle than tax rate changes.

Conclusion:
Often lost in discussions on dividend taxation is the fact that dividends are paid out to investors from corporations' after-tax income. In view of that, one could make a well-reasoned argument that the "appropriate" tax rate for dividends is 0%. While this idea resonates with us, given that the alternative constitutes a form of "double taxation," its torch has not, unfortunately, been aggressively carried by many members of Congress, and is likely to fall on especially deaf ears in the current fiscal environment.

Despite this unfortunate outlook for the trend in dividend taxation, our research, as outlined above, gives us confidence that neither dividend stock performance nor corporate distribution policy will see a detrimental impact from the potential tax rate changes contemplated by existing legislation to occur next year.

1 "U.S. Federal Individual Income Tax Rates History, 1913-2011 (Nominal and Inflation-Adjusted Brackets)," Tax Foundation, September 2011, http://www.taxfoundation.org/publications/show/151.html
2 Copeland Capital Management (data from FactSet)
3 Copeland Capital Management (data from http://w4.stern.nyu.edu/~adamodar/New_Home_Page/datafile/spearn.htm)
4 Ned Davis Research, April 2011
5 "Dividends Rate Change," Standard & Poors, June 2012, http://www.standardandpoors.com/general/generalsearch/en/us/?search=dividends

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For more information about Copeland Capital Management or any of our traditional, tactical, or alternative dividend growth strategies, please contact Chuck Barrett, Director of Sales and Marketing, at (484) 351-3665 or cbarrett@copelandcapital.com

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